

FINANCIAL POLICIES AND THE BANKING SYSTEM IN ZAMBIA

Martin Brownbridge

Summary

For over 20 years until the early 1990s Zambia had entailed extensive government ownership and administrative controls over markets, including financial and banking markets. Interventionist policies, combined with a steep fall in the external terms of trade, led to economic decline. A major programme of market oriented economic reforms was adopted in the early 1990s which included financial sector reforms.

The aim of this paper is to explore a number of related hypotheses. First, that interventionist financial policies were either ineffective in changing the way that banks allocated credit and/or had a negative impact on the strength of the banking system: interest rate controls led to disintermediation in conditions of high inflation when real rates were highly negative, attempts by government owned banks to extend loans to meet development objectives undermined their solvency, while administrative controls or moral suasion had little impact on the operational policies of the foreign banks which remained very conservative in their policies. Second, that prudential regulation was not accorded sufficient priority with adverse consequences for financial fragility in the banking system, especially when locally owned private sector banks were set up in the 1980s and early 1990s. Third, that financial reforms are difficult to implement effectively and probably have a limited impact on the efficiency of resource allocation by the banking system, especially in conditions of macroeconomic instability. The major constraints to improving efficiency are institutional in character and cannot be rectified quickly.

The author is a former IDS Research Officer. At the time of publication (June 1996) he was working for UNCTAD (Division for Least Developed Countries) in Geneva, Switzerland.

FINANCIAL POLICIES AND THE BANKING SYSTEM IN ZAMBIA¹

Martin Brownbridge

1 INTRODUCTION

For over 20 years until the early 1990s Zambia pursued predominantly interventionist economic policies which entailed extensive government ownership and administrative controls over markets, including financial and banking markets. Interventionist policies, combined with a steep fall in the external terms of trade, led to economic decline, and a major programme of market oriented economic reforms was adopted in the early 1990s which included financial sector reforms.

This paper examines how financial policies shaped the evolution of the banking sector in Zambia since independence. The aim is to explore a number of related hypotheses. First, that interventionist financial policies were either ineffective in changing the way that banks allocated credit and/or had a negative impact on the strength of the banking system: interest rate controls led to disintermediation in conditions of high inflation when real rates were highly negative, attempts by government owned banks to extend loans to meet development objectives undermined their solvency, while administrative controls or moral suasion had little impact on the operational policies of the foreign banks which remained very conservative in their policies. Second, that prudential regulation was not accorded sufficient priority with adverse consequences for financial fragility in the banking system, especially when locally owned private sector banks were set up in the 1980s and early 1990s. Third, that financial reforms are difficult to implement effectively and probably have a limited impact on the efficiency of resource allocation by the banking system, especially in conditions of macroeconomic instability. The major constraints to improving efficiency are institutional in character and cannot be rectified quickly.

The paper is organised as follows. Section 2 details the main components of financial sector policies during the period of interventionist economic policies in Zambia, and assesses the impact of financial repression on the financial depth of the economy. A key facet of the government's financial policies was the establishment of a major government owned bank, the Zambia National Commercial Bank (ZANACO), the operational focus and performance of which is discussed in Section 3. Section 4 examines the role of the foreign owned banks. From the mid 1980s the local private sector began to set up banks in Zambia. Section 5

¹ The author thanks Charles Harvey, Institute of Development Studies, for comments on this paper, but accepts responsibility for all errors.

explores the growth, operational focus and problems of the local banks. The financial sector reforms are described and assessed in Sections 6 and 7. Section 6 considers the liberalisation of financial markets and its impact on deposit mobilisation and allocative efficiency, while Section 7 examines the reforms to prudential regulation and discusses the problems facing the regulators in dealing with distressed banks. Section 8 concludes.

2 FINANCIAL POLICIES

The course of Zambia's post independence economic strategy was shaped by the 1968 Mulungushi declaration. The strategy, motivated by economic nationalism and the desire to redress political and economic inequalities, entailed state led import substituting industrialisation and extensive government controls over resource allocation. Some of the foreign companies operating in Zambia were nationalised, a large parastatal sector was created and administrative controls were imposed over foreign exchange, imports, prices and interest rates (Mutukwa, Appendix, pp 1-2). Economic performance however was very poor: the economy was severely affected by the steep fall in the price of copper from the mid 1970s, while the interventionist policies led to inefficiencies and structural rigidities which impeded adjustment to external shocks. A series of IMF stabilisation programmes were implemented, beginning in 1976, in an attempt to tackle the economic crisis, but, apart from a short period during 1985-87, the government persisted with the main components of the interventionist strategy until the late 1980s/early 1990s (Fardi 1991; Jones 1994).

The financial system in the mid 1960s was dominated by foreign commercial banks mainly serving the credit needs of foreign and expatriate businesses. The general thrust of financial policies after 1968 was to enable government to exert greater control over the financial system and to ensure that credit allocation was more supportive of the government's overall economic strategy. Financial policies consisted of three main strands: nationalisation of foreign financial institutions, establishment of government owned banks and development finance institutions, and administrative controls over interest rates and, to a limited extent, loan allocation.

2.1 NATIONALISATION OF FOREIGN FINANCIAL INSTITUTIONS AND THE ESTABLISHMENT OF GOVERNMENT OWNED FINANCIAL INSTITUTIONS

ZANACO was established by the government in 1969. Its objectives included the provision of credit to Zambians and the extension of bank branches into the rural areas (Musokotwane, p 12). The government however soon realised that ZANACO would be unable to expand rapidly enough to meet the expectations placed on it, and in 1971 announced plans to nationalise all the foreign financial institutions, including the commercial banks (Harvey 1991: 262).

The objective of nationalisation was to control the 'commanding heights' of the economy and to prevent capital flight. Most of the non bank financial institutions were nationalised and amalgamated to form financial parastatals such as the State Insurance Corporation and Zambia National Building Society (Musokotwane, pp 8-9). But with one exception (the Nederland Bank) the banks were not nationalised because the foreign banks threatened to withdraw their expatriate management and the Zambian government was not confident that it could manage the banks without them (Harvey 1993: 7).

Several other banks and non bank financial institutions were set up by the government to serve various purposes. The Indo-Zambia Bank was established in 1984 as a joint venture between the government and three state owned Indian banks, and in 1987 the Zambia Export and Import Bank was founded to supply trade finance. Development finance institutions were set up to provide concessional and/or long term finance to priority sectors with funds mobilised from the government or external sources. These included the Zambia Agricultural Development Bank and Agricultural Finance Company, which were amalgamated to form the Lima Bank in 1987, and the Development Bank of Zambia.

2.2 INTEREST RATE AND OTHER ADMINISTRATIVE CONTROLS

The third strand of the government's financial policies consisted of the imposition of administrative controls over financial institutions. With the exception of interest rates however, direct administrative controls over resource allocation in the banking system were not extensively employed by the government: there were no detailed sectoral credit guidelines, for example. The government did attempt to channel more credit towards Zambians by requiring banks to seek Bank of Zambia (BOZ) permission before lending to foreign companies and by imposing lower maximum gearing ratios on foreign borrowers than Zambian borrowers. This failed to induce a major expansion of lending to private sector Zambians, and in an attempt to rectify this, the government established a credit guarantee scheme for small scale industries in 1987 (Musokotwane, pp 20-24).²

The lack of more extensive administrative controls to direct the pattern of bank lending was probably for two reasons. First, foreign exchange controls already provided the authorities with a powerful tool for directing resource allocation in the economy. Given the severe constraints on foreign exchange availability, firms with access to foreign exchange would generally have been creditworthy borrowers while those without would not: hence foreign exchange allocation exerted indirect influence over credit allocation and obviated the need for more direct credit controls. Second, given the weaknesses of the domestic private sector, the bias against agriculture in pricing policies and the economic crisis which afflicted Zambia

² The banks were also subject to statutory reserve and liquidity requirements and, at times, credit ceilings for monetary policy purposes.

from the mid 1970s, banks would almost certainly have had great difficulty in identifying creditworthy borrowers had they been instructed to lend to those sectors favoured by government rhetoric, notably agriculture.

To further the objectives of extending banking into rural areas the BOZ imposed a requirement on the commercial banks that, after their first four branches had been set up, they should set up a rural branch for each new urban branch established.

Beginning in the mid 1960s, the deposit and lending rates of the commercial banks were controlled by the BOZ which maintained a policy of low interest rates in order to minimise borrowing costs. Until 1984 commercial bank deposit rates were held within a range of 3.5 per cent and 8.5 per cent and lending rates between 7 per cent and 13 per cent (Musokotwane, pp 33 and 55). In addition a preferential rate was stipulated for agricultural lending from 1978. Nominal rates were generally held below the rate of inflation, which averaged 10 per cent during the 1970s and 20 per cent during 1980-84.

There was an increase in both inflation and nominal interest rates from the mid 1980s onwards. The implementation of a stabilisation programme led to a small rise in administered interest rates in 1984 and the decontrol of interest rates and introduction of a treasury bill auction in September of the following year. Lending rates rose sharply thereafter - to around 30 per cent in 1986 - although because this was accompanied by an acceleration of inflation real interest rates remained negative. Interest rate controls were reimposed in May 1987 following the breakdown of an IMF supported adjustment programme, and held below 20 per cent for the remainder of the decade. The government adopted a new IMF supported adjustment programme in 1989 under which interest rates were again raised, although they remained far below prevailing inflation rates which had by this time reached levels in excess of 100 per cent per annum. During the 1990s interest rates were again raised and then liberalised (Mulaisho 1994). The impact of financial liberalisation is discussed in Section 6.

2.3 THE IMPACT OF INTEREST RATE CONTROLS ON FINANCIAL DEPTH

Until the second half of the 1980s negative real interest rates did not have adverse effects on the financial depth of the economy - the M2/GDP ratio increased from 29.2 per cent in 1970 to 34.6 per cent in 1984 - probably because they were not sufficiently negative to provide a serious deterrent to the holding of monetary assets. In addition foreign exchange controls prevented the major institutional actors in the economy (most of which were the parastatals) from holding foreign currency as a substitute for domestic financial assets (Adam 1995: 746). From the mid 1980s onwards however inflation accelerated, averaging 68 per cent during 1985-90, and this led to much more sharply negative real interest rates. By the end of

the 1980s the economy's financial depth was diminishing rapidly: the M2/GDP ratio fell from 33.7 per cent in 1988 to 21.5 per cent in 1990 (see Table 2).

3 THE PERFORMANCE OF ZANACO

ZANACO was established by the government in 1969 with the objectives of meeting the credit needs of indigenous Zambians who had difficulty accessing loans from the foreign banks, and of extending banking into the rural areas. Since 1978 it has been a subsidiary of the Zambia Industrial and Mining Corporation (ZIMCO), the holding company for most of the parastatal corporations. ZANACO has become the largest bank in Zambia after experiencing rapid growth. In 1991 it had 26 per cent of total commercial bank deposits and 31 per cent of loans. It also has the largest branch network among the commercial banks, with around 40 branches in the early 1990s.³

ZANACO's main customers have been the parastatals, to which it has extended short term credit for working capital. Despite the fact that one of its objectives was to finance indigenous businesses it has been reluctant to become heavily exposed to this sector, and especially to small farmers, although agricultural lending did increase in the 1990s after the credit guarantee scheme was introduced. Musokotwane (p 14) attributes this caution to ZANACO having sufficient autonomy to resist political pressure to lend to small farmers, which it would have regarded as being uneconomic.

ZANACO's financial performance during the 1980s appears, from its published accounts, to have been reasonably good. It was consistently profitable, with pre-tax operating profits during 1981-89 averaging more than 50 per cent of its capital and reserves and around 2.5 per cent of total assets.⁴ It also had a good reputation among bankers: it was regarded as well managed with bad debts believed to be a small share of total loans (Harvey 1993: 10-11). The foreign banks were willing to extend credit to ZANACO on the interbank market, which contrasts with the attitude taken by their counterparts towards government owned banks in some other African countries. However ZANACO's published accounts do not make clear the magnitude of provisions made for doubtful loans or (until 1992/93) the basis on which they were made: nor is it clear whether unpaid interest was accrued as income or not. Hence ZANACO's actual profitability may have been overstated.⁵ It is possible that ZANACO's

³ The National Savings and Credit Bank (the former Post Office Savings Bank) - which is classified as a non bank financial institution - has a much larger network of branches.

⁴ Data from Zambia National Commercial Bank 1990, Annual Report and Accounts, pp 14-15.

⁵ In the absence of specific guidelines from the regulatory authorities, which were not introduced until 1994, whether non performing loans are classified as bad debts depends to a large extent on how much value the lender attributes to government or other public sector guarantees (for loans to parastatals) and/or the collateral provided by the borrower. It is possible that ZANACO regarded most of its parastatal lending as being secure because of guarantees given by the government or ZIMCO and/or

loan portfolio was more seriously impaired during the 1980s than was evident from its published accounts, but that the impact on its financial position - in particular its profitability and liquidity - was limited for two reasons. First, loans and advances as a share of total assets were not particularly large (generally around 45 per cent). Second, although gross earnings would have been reduced to the extent that loans were not serviced, the impact of this on profitability would have been mitigated because both deposit and lending rates were low as a result of administrative controls: i.e. the controls served to hold down ZANACO's interest costs. ZANACO's financial position may also have benefited because its branch network was relatively small in comparison to that of many of the other government owned banks in Africa: it was therefore able to avoid the operating losses which might have been incurred had overheads been higher.⁶

ZANACO continued to record strong profits until the 1992/93 financial year, the most recent year for which published accounts were available in mid 1995.⁷ However it is clear that non performing loans were becoming a more serious problem. ZANACO's 1992/93 accounts noted that the government was intending to replace Kw1.9 billion (13 per cent of its loan portfolio) in loans to Nitrogen Chemicals of Zambia (a large parastatal) with five year government bonds. By 1995 ZANACO's position had deteriorated markedly. Sources in the banking industry indicated that a large share of its loan portfolio was not being serviced, with adverse effects on its liquidity position. Lending to parastatals, some of which were in the process of being privatised and others liquidated, accounted for the bulk of the non performing loans. Loans for agriculture and agricultural marketing were also in arrears. Although most of its loans had been disbursed as overdrafts, they had effectively acquired the characteristics of long term loans, as a result of the borrowers' inability to meet servicing commitments. Whether ZANACO is insolvent as a result of its impaired loan portfolio is dependent upon how much of the collateral can eventually be recovered: many of the parastatals to whom it has lent are unlikely to be viable in the future and will have to be liquidated and their assets sold if ZANACO is to be repaid.⁸

The deterioration in ZANACO's financial position was probably due to a combination of reasons. First, trade liberalisation, exchange rate devaluation and interest rate rises have undermined the viability of import substituting industries. Many of the parastatal manufacturers had enjoyed a monopoly position in the domestic market which helped to

because it was secured by the tangible assets of the borrowers, and hence did not feel it was necessary to make provisions when loans to parastatals were not serviced.

⁶ By way of comparison the Uganda Commercial Bank had 190 branches at its peak, and the Tanzanian National Bank of Commerce had 203.

⁷ The financial year ends in March. The delay in publishing accounts for 1993/94 and 1994/95 is in itself indicative of financial difficulties.

⁸ It is possible that the privatisation proceeds of those parastatals which are privatised will be used to repay loans.

ensure that they were profitable until the late 1980s/early 1990s when trade liberalisation exposed them to competition. Second, the quality of agricultural loans, albeit a less significant component of ZANACO's portfolio, has been impaired by drought, high interest rates and the liberalisation of the agricultural marketing system. Third, ZANACO's liquidity position was undermined because higher nominal interest rates have increased the cost of ZANACO's deposits, whereas they have not had a commensurate effect on its loan income because loans were not serviced. Fourth, arrears on non performing loans quickly multiply when interest rates reach the levels (of around 100 per cent) which prevailed in 1993 and 1994. Fifth, given the government's acute fiscal constraints, its ability to honour loan guarantees is uncertain. Hence guaranteed loans which had been considered secure may now not be recoverable.

As of mid 1995 a comprehensive plan to address ZANACO's financial problems had yet to be worked out. ZANACO's management had started to reform the bank's organisational structure and were planning to review credit policies. The rationalisation of its branch structure and staffing levels appears necessary to reduce operating costs. ZANACO is likely to need a capital injection, and probably the restructuring of its asset portfolio, with some of the non performing loans replaced with income earning assets. Asset restructuring will entail the provision of government funds, probably in the form of government bonds. Recapitalisation is relatively straightforward but, depending upon the scale of non performing assets, will probably be expensive. To ensure future viability, changes in management practices (e.g. lending policies) will be needed, which may be more difficult to accomplish. The management expertise necessary to extend loans on commercial principles may be lacking given that most of ZANACO's lending has been to parastatals. Even if the expertise is available, re-establishing commercially sound lending will be difficult in the prevailing unstable economic climate. If ZANACO is restructured it is possible that a privatisation or partial privatisation might then be used to increase its capital base, as was done with the two government owned commercial banks in Kenya, although private investors would need to be confident that ZANACO's balance sheet was sound and that its management had the ability and independence from government to manage the bank along strictly commercial lines.

4 FOREIGN BANKS

During the colonial period three major foreign banks, Barclays, Standard and ANZ Grindlays, established operations in Zambia, and dominated the banking system at independence. The government had planned in 1971 to nationalise the foreign banks by purchasing 51 per cent share holdings, but this plan was not implemented, as noted in Section 2. The foreign banks were required to be incorporated in Zambia, and thus formed boards of directors which included Zambians, but senior management remained in expatriate hands.

Barclays and Standard have retained substantial shares of the banking market (approximately 20 per cent and 16 per cent respectively of total bank deposits in 1991) but their market share has been reduced by the growth of ZANACO, Meridien and other local banks. Both have nation-wide retail branch networks, although Standard, in line with its global policy, is now retrenching in Zambia to concentrate on corporate and trade finance, and announced the sale of some of its branches to Finance Bank (a bank owned by local private sector investors: see Section 5) in 1995. Grindlays was purchased by Stanbic in 1992: it has a much lower market share and focuses on the corporate sector. During the early 1980s two more foreign banks established subsidiaries in Zambia: Citibank, which has concentrated on corporate finance and Bank of Credit and Commerce International (BCCI). The latter - known as Bank of Credit and Commerce Zambia (BCCZ) - expanded rapidly by offering innovative services and attracting business from parastatals to capture 7.5 per cent of total bank deposits by 1989. It was purchased by Union Bank (another local private sector bank) in 1991 after its parent company was closed down.

The remainder of this section examines the operations and performance of Barclays and Standard. The nature of their operations in Zambia has been similar to those in many of the other African countries in which they have subsidiaries. They have provided short term loans and letters of credit mainly to the larger private sector companies. They had already secured the prime borrowers in the economy during the colonial period and were able to retain most of them as customers despite competition from new banks since independence. Their lending policies have been conservative and as result they have generally avoided incurring substantial levels of bad debts. Loans have not comprised a large share of their total assets. Despite discontent with the orientation of their lending policies, they appear to have been able to avoid pressure to extend loans to less creditworthy borrowers, such as small farmers, except on a rather limited scale (and often with guarantees provided by third parties). Standard has been more heavily involved in lending to agriculture, and both banks' loan portfolios were adversely affected by the problems in this sector in the 1990s.⁹ Lending to parastatals, sometimes with government guarantees, has comprised a small share of their loan portfolios: it appears to have been relatively trouble free, unlike ZANACO's lending to this sector.

Barclays and Standard have faced pressure from the BOZ to open (or not to close existing) rural branches, and this has contributed to the size of their branch networks. Despite high overheads, Barclays and Standard have generally been profitable because the cost of their

⁹ Lending to agriculture accounted for 31 per cent of Standard's loans in 1994 (data from its Annual Report and Accounts). Many of these loans are non performing because of the problems in the agricultural sector in the 1990s (drought and high interest rates together with the liberalisation of agricultural marketing). Barclays also suffered from non performing loans to agriculture for the same reasons, although it was less heavily exposed to the sector.

deposits has been low and loan losses have been limited. They have also enjoyed oligopolistic positions in the banking market, which is surely one of the main reasons why neither has provided very efficient customer services, although they argue that this is partly attributable to the foreign exchange controls which prevented them from upgrading technology.

5 THE GROWTH OF LOCAL BANKS IN ZAMBIA

The Zambian private sector first entered the banking industry in 1984 when Meridien Bank, was founded. By mid 1995 there were around 13 banks owned by local private sector investors (henceforth local banks) in operation in Zambia. Most of these banks began operating during the first half of the 1990s. At a time when most sectors of the economy were suffering from recession, the banking sector experienced remarkable growth. This section examines the reasons why local banks have been set up in such numbers, the main characteristics of, and problems facing, these banks and the failures among local banks which have occurred in the 1990s.

5.1 REASONS FOR THE ESTABLISHMENT OF LOCAL BANKS

The first local banks in Zambia were established during a period when financial policies were not particularly conducive to private sector investment in banking. Interest rates were tightly controlled, which together with high reserve requirements, depressed profit margins, and bank licenses were very difficult to obtain, apparently because of political considerations rather than any stringency in the legal requirements of the Banking Act.¹⁰ Nevertheless opportunities did exist to exploit the gaps left in banking markets by the inefficient provision of services and the conservative orientation of the established public sector and foreign banks, as was demonstrated by the rapid growth of BCCZ. Some local investors were able to obtain banking licenses, including Andrew Sardonis who founded Meridien. Four more banks were set up in the second half of the 1980s, including Finance Bank in 1987 and Capital Bank in 1989: the latter was owned by opposition politicians.

After the Movement for Multiparty Democracy (MMD) won power at the 1991 elections it became much easier to obtain a banking license. Furthermore inflation had reduced the real value of the minimum capital requirement to around \$300,000 in 1991, and little more than \$50,000 by the end of the following year. Hence the entry requirements into the banking

¹⁰ The Minister of Finance had ultimate authority over the granting of banking licenses. Licensing requirements under the Banking Act are discussed in the following section.

industry were substantially reduced and this allowed around nine new banks to be set up by local private investors, and to commence operations during 1991-95.

The primary motivation for the establishment of most of these banks was the large profits to be earned from foreign exchange dealing, and from investing borrowed money in treasury bills, rather than from conventional lending activities. The liberalisation of foreign exchange markets beginning in 1990 and extended in 1992 allowed the banks to deal in foreign exchange and fund external trade. The large government domestic borrowing requirement combined with the introduction of market determined interest rates led to very high treasury bill interest rates: 91 day treasury bill yields rose to 182 per cent in June 1993 after the treasury bill auction was introduced (Bank of Zambia 1993: 63). The extent to which the local banks relied on treasury operations to generate their earnings is indicated by the fact that government securities were among the largest component of the asset portfolios of almost all of the local banks (and some of the foreign banks as well) during 1992-93.¹¹

Most of the banks set up in the 1990s are owned by members of the Asian business community, with former managers of BCCZ (which had been run by Asian management) playing leading roles in the management of several of these banks, whereas, with the exception of Finance Bank, the local banks established in the 1980s were set up mainly by African investors and/or those of European origin.

5.2 CHARACTERISTICS OF LOCAL BANKS

A few of the local banks have grown into major participants in the banking market. Before its collapse in April 1995 Meridien had become the fourth largest bank in Zambia and had established banking operations in another 19 African countries.¹² It had aggressively competed for market share from the established banks by offering innovative services to customers. Finance Bank has also grown rapidly to attain a market share of more than 6 per cent by early 1995. It purchased rural branches from Standard in 1995 to facilitate its expansion into the rural areas and has established a subsidiary in Malawi. Union Bank, which took over the local operations of BCCZ in 1991, is also quite large but most of the other local banks are much smaller.

¹¹ Treasury bills accounted for an average of 28 per cent of the total assets of a sample of six local banks at the end of the 1993 financial year, compared to loans and advances (net of provisions) which accounted for only 15 per cent of total assets. Data from Annual Reports of local banks.

¹² The parent company for the African subsidiaries was Meridien BIAO - formed out of the merger of Meridien and the Banque Internationale pour l'Afrique Occidentale (BIAO) in 1991, whose headquarters were in Luxembourg before being moved to Zambia in January 1995. The Zambian subsidiary was called Meridien BIAO Zambia (MBZ). MBZ is discussed here as a local bank because Meridien had its origins in Zambia.

Mobilising deposits has been a major concern for most of the local banks and the area where competition is at its most intense. The local banks have deployed a variety of strategies to compete: paying higher interest rates and offering better rates for foreign currency trades; accepting, and paying interest on, smaller minimum deposit balances; offering flexible deposit terms (e.g. allowing depositors to withdraw money before term), aggressive marketing; providing quicker and more personalised services than the established banks, and opening longer and more flexible hours. Some of the methods employed to attract deposits, in particular offering above market interest rates, threaten to undermine the viability of the local banks, while others, such as providing more personalised services, might be more affordable and sustainable in the long term.

As noted above loans have not formed a major component of the local banks' asset portfolios during the 1990s. Loan demand from creditworthy borrowers has been depressed because of the economic recession and high interest rates, while government securities have offered a more attractive investment option for the banks than lending to the private sector. Most of the loans which the local banks have extended are short term and focused on local traders. There is also some limited lending to small manufacturers and parastatals but only Finance Bank has lent heavily to agriculture. Lending to large borrowers is constrained by exposure limits.¹³ Interbank loans have also become a lucrative, if potentially risky, investment for the local banks with interbank rates reaching as high as 70 per cent in response to the liquidity shortages faced by some of the local banks.

5.3 PROBLEMS OF THE LOCAL BANKS

The local banks face a number of problems which potentially threaten to undermine their ability to compete and survive, including the high cost of funds, shortages of liquidity, the erosion of earnings from treasury and foreign exchange operations, poor loan quality and shortages of capital.

The local banks have to pay much higher interest rates to mobilise deposits than the established banks mainly because they lack the latter's reputation for safety. Moreover most of the local banks have not been able to access the major sources of large deposits: the multinationals operating in Zambia deposit their funds with foreign banks while most of the parastatals use ZANACO.¹⁴ Liquidity has become a major constraint for many of the local banks, exacerbated by several recent developments. Following the collapse of Meridien,

¹³ The exposure limits are set at 25 per cent of capital and reserves in the 1994 Banking and Financial Services Statute. At least one of the local banks had ignored these limits in lending to one of the larger parastatals. Because the legal status of the exposure limits was still that of guidelines rather than regulations in mid 1995, they could not be enforced by the BOZ.

¹⁴ A few of the local banks rely heavily on parastatal deposits, although this is a risky strategy as the experience of the Capital Bank in 1991, which is discussed below, demonstrates.

deposits were transferred from some of the local banks to the larger established banks. Moreover the BOZ raised the statutory liquid asset ratio from 20 per cent to 30 per cent in June 1995: when the rise took place 14 banks were unable to meet their statutory liquidity requirements. As a consequence several local banks have offered very high interest rates for short term deposits and/or had to borrow extensively on the interbank market at interest rates of between 50 per cent and 70 per cent during 1995.

Partly because they must charge much higher lending rates to cover the cost of their funds, the local banks lend to many of the borrowers who have been rejected by the established banks (or would be were they to apply for loans). Some of these borrowers are clearly less creditworthy than the prime borrowers served by the foreign banks, hence adverse selection problems threaten to undermine the quality of the local banks' loan portfolios. Loan servicing has been a problem for most of the banks: several of the local banks have made provisions for doubtful debts amounting to between 20 per cent and 40 per cent of their total loans.¹⁵

Poor loan quality has not yet had serious consequences for most of the local banks because loans have made up a relatively minor portion of their total assets, and because income has been generated from foreign exchange dealing and investment in treasury bills. But both these sources of income have started to decline. Competition has reduced spreads on foreign exchange trades and the improvement in the fiscal deficit has substantially lowered treasury bill rates. Consequently the local banks will have to rely much more on loans to generate income, but unless the proportion of loans which are non performing is significantly reduced, they are likely to suffer heavy losses which will threaten their solvency. Given the extent of interbank lending among the local banks, there is also a danger that defaults on interbank loans might have systemic effects on fragility in this sector.

Most of the local banks also require additional capital. They were established at a time when the minimum capital requirement was very low. This was raised to Kw1.25 billion in the 1994 Banking and Financial Services Act with the existing banks given until June 1996 to meet the new requirement, but as of mid 1995 several of the local banks were a long way short of the target. Their owners may be reluctant to inject additional capital into these banks given that prospects for future profitability now appear to less promising, for the reasons discussed above.

5.4 BANK FAILURE

Bank failures have so far afflicted four of the local banks in Zambia. Capital Bank was closed for reasons which remain contentious largely because of the political controversy surrounding this episode. It began suffering from liquidity shortfalls in 1990 after a rapid

¹⁵ Data from Annual Report and Accounts of local banks.

expansion of its loan portfolio and was forced to seek liquidity from the BOZ. The BOZ accommodated its liquidity needs for several months, but in early 1991 Capital Bank suffered another liquidity crisis when some of its parastatal deposits were withdrawn and government allegations that it had lent money to its own directors, who were leading opposition politicians, contributed to a run on the bank. It received further liquidity support from the BOZ but was closed down in May 1991 after a BOZ inspection, instigated, according to Capital Bank, by the government to discredit the opposition. That some of its creditors were not fully reimbursed when a settlement of the bank's debts was eventually reached indicates that it was insolvent.¹⁶ After the 1991 elections Capital Bank was recapitalised, with additional shareholders and new management brought in, and it reopened in 1992 as New Capital Bank. It has since implemented a debt recovery strategy and managed its assets very conservatively.

Meridien BIAO Zambia (MBZ) - the Zambian subsidiary of Meridien BIAO - was closed in April 1995 following the closure of Meridien subsidiaries in Swaziland and Kenya. The reasons for MBZ's collapse have not yet been made public, but it seems likely that they were connected with problems afflicting the parent company, Meridien BIAO, which was clearly undercapitalised, faced an acute liquidity shortage and had probably expanded far too rapidly. It was reported that funds had been transferred from the subsidiaries in Africa to Meridien BIAO's own parent company (Meridien International Bank Ltd.) in the Bahamas. Other financial irregularities, including insider lending and doctoring of financial data, were discovered by a BOZ inspection of MBZ in February 1995 (Bull and Simpson 1995: 17).

Two more local banks, African Commercial Bank (ACB) and Commerce Bank were closed in late 1995. The former was reported to be suffering from acute liquidity problems while the latter had failed to comply with a request from the BOZ to replace its Chairman, who was also a director of the ACB (African Business 1995: 25-26).

Given the problems facing many of the local banks, further episodes of bank distress in Zambia are not unlikely. There are two main dangers for bank solvency in this sector. First, with income from safe assets, such as treasury bills, falling, the local banks may attempt to maintain profitability by expanding lending to more risky borrowers prepared to pay high lending rates. Second, the owners of several of the local banks have other non banking business interests: these banks may be used to channel credit to the businesses of their owners as has happened elsewhere in Africa. Preventing this from happening, and/or taking

¹⁶ The settlement (called a scheme of arrangement) involved the major depositors exchanging their deposits for bonds. The bonds have a face value of 80 per cent of the deposits they replaced and yield a below market interest rate. The new shareholders are the Cavmont Group which also own the Cavmont Merchant Bank in Zambia.

action to remedy it before depositors' money is lost, will be a major challenge for bank supervisors, as discussed in Section 7.

6 FINANCIAL LIBERALISATION

Apart from the relatively short period from September 1985 to May 1987 when interest rates were temporarily decontrolled, financial sector reforms have only recently been implemented. Financial reforms have comprised two main components: financial liberalisation which included the liberalisation of foreign exchange markets and interest rates in 1992-93, and reforms to the system of prudential regulation and supervision of financial institutions, which included the enactment of new banking legislation in 1994. A third component was the de facto liberalisation of access to banking licences which enabled the number of local banks to expand rapidly during 1991-94, although to what extent this was a deliberate policy decision is unclear. The reforms have not yet included measures to restructure distressed public sector banks, but given the scale of ZANACO's non performing loans, this is likely to be necessary in the near future. This and the following section examine the financial reforms implemented in Zambia and present an assessment of their efficacy (which must inevitably be very tentative given that the reforms are so recent). Financial liberalisation is discussed in this section while Section 7 examines the reforms to the prudential system.

Financial liberalisation was undertaken in Zambia in conditions of acute macroeconomic instability. Central bank financing of a very large fiscal deficit led to a 95 per cent increase in broad money and a consumer price inflation rate of 93 per cent during 1991.¹⁷ Interest rate controls during 1991 limited the maximum lending rate to 46 per cent and the savings deposit rate to 33 per cent: hence real interest rates were substantially negative. Although the fiscal deficit was reduced in the following year, inflation accelerated to 193 per cent by the end of 1992.

The financial policy objectives of the government in 1992 were to reduce inflation and to move towards positive real interest rates. Interest rate controls initially remained in force but interest rates were adjusted upwards: the maximum lending rate was raised to 53 per cent by June 1992. Meanwhile a market determined exchange rate was introduced, with foreign exchange controls substantially liberalised and the banks allowed to deal in foreign currency: this led to a sharp depreciation of the exchange rate during 1992. In September 1992 bank interest rates were decontrolled, and a treasury bill auction was introduced in January 1993 which allowed treasury bill rates to be market determined. The latter brought about a steep rise in treasury bill rates - 91 day treasury bill yields rose from 47 per cent in December 1992 to 181.8 per cent in June 1993 - and this pushed up bank deposit and lending rates: savings

¹⁷ The statistical data in this section are taken from Bank of Zambia Annual Reports and Quarterly Financial and Statistical Reviews, unless otherwise stated.

deposit rates rose to 90 per cent and lending rates to 133 per cent in June 1993. Inflation and nominal interest rates began to subside in the second half of 1993 after the government adopted a cash budget for its primary expenditure (i.e. all expenditure other than debt servicing). The inflation rate was reduced to 100 per cent and the 91 day treasury bill yield fell to 85.4 per cent in March 1994.

The objectives of financial liberalisation include boosting deposit mobilisation and enhancing the efficiency of credit allocation. Liberalisation did not boost deposit mobilisation: deposits as a percentage of GDP fell from 17.9 per cent in 1991 to 10.4 per cent in 1994, although they had been on a downward trend since the late 1980s.¹⁸ One of the reasons why financial liberalisation failed to halt the trend towards financial shallowing in Zambia was probably that the removal of foreign exchange controls allowed economic agents to legally hold foreign currency assets. Bank deposits may also have been diverted into treasury bills as treasury bill yields surpassed bank deposit interest rates during 1993 and 1994 (Adam 1995). Higher deposit rates would have made domestic currency deposits more attractive to savers than they had been prior to interest rate liberalisation, but they remained well below the rate of inflation until 1994. Relative to alternative financial assets, liberalisation probably made bank deposits less attractive to savers in Zambia.

It is not clear whether liberalisation enhanced the efficiency of credit allocation in the banking system. The combination of very high nominal lending rates and inflation greatly increase the risks of bank intermediation for both the banks and their borrowers, making it likely that both loan demand and the willingness of banks to supply credit will be curtailed (Harvey and Jenkins 1994: 1874-77). Evaluating loan applicants is especially problematic in such conditions, so that even if liberalisation allowed banks to adopt more explicitly commercial criteria in allocating and pricing credit a more efficient allocation of credit would not be guaranteed. In addition the volume of creditworthy borrowers to which the banks could lend was limited, especially because the formal sector was still dominated by parastatals, many of which have experienced acute financial difficulties.

There is a case for arguing that financial liberalisation was premature, and that it should have been delayed until the fiscal deficit and monetary growth had been brought under control. The arguments for this are twofold. First, lower nominal interest rates would have reduced the risks of loan defaults by borrowers, and by implication helped to protect the loan portfolios of the banks. Second, if liberalisation did undermine the monetary base and therefore increase the velocity of circulation of money by inducing agents to substitute non monetary for monetary assets, reducing inflation would have been made more difficult and

¹⁸ Data from Economist Intelligence Unit Country Profile 1995-96.

would have required a greater deceleration in the growth of money supply, and therefore imposed a larger burden on fiscal contraction (Adam 1995).

7 BANK REGULATION AND SUPERVISION

Major reforms to the system of prudential regulation and supervision of the financial system began in 1994. As in many other African countries the prudential framework put in place during the colonial period and the early years of independence was not adequate to effectively regulate the banking system, especially as the latter evolved during the 1980s. There were serious deficiencies in both the banking legislation and the supervisory capacities in the BOZ.

Prior to the economic reforms of the 1990s, the BOZ's main role was in ensuring compliance with government imposed allocative regulations. Prudential regulation was not a priority, and bank inspections concentrated on checking that banks complied with foreign exchange and interest rate controls as well as statutory liquidity requirements (Bank of Zambia 1994). The BOZ also acquired an equity stake in ZANACO, which clearly would have compromised its role as the bank regulator had the latter been taken more seriously. To some extent the lack of emphasis accorded to prudential regulation was justifiable: until BCCZ and Meridien were set up in the early 1980s, the banks operating in Zambia were either owned by well established foreign banks or the government, and thus reasonably secure in terms of the safety of deposits. It was also the case that the controlled economy provided a relatively safe environment for bank lending.

However with the advent of BCCZ and the local banks, a much more purposeful approach to prudential regulation and supervision was required. The fact that reforms to the prudential system were delayed until 1994 has almost certainly cost the taxpayers heavily as a result of the Meridien collapse and may result in further costs if many more of the local banks fail. The potential fragility among the local banks is at least partly attributable to the fact that the revisions to the banking legislation were not enacted until three years after a more liberal attitude to bank licensing was adopted. Substantial new entry into the banking industry was allowed before adequate prudential legislation and supervisory capacities had been put in place.

Between 1965 and 1994 the legislative framework governing the banking industry was contained in the Banking Act and Bank of Zambia Act (Chapters 700 and 699 of the Laws of Zambia). Various aspects of these Acts impeded effective prudential regulation.

First, the authority to license banks, and to withdraw licenses, lay not with the BOZ but with the Registrar of Banks appointed by the Ministry of Finance (MOF). Second, the Banking Act did not provide the BOZ with the authority to issue or update regulations pertaining to

prudential requirements. One consequence of this was that the minimum capital requirement to set up a bank, which had been set in the Banking Act at Kw2 million (worth \$3 million in 1971) remained unchanged until 1989 by which time it was worth \$150,000. It was then raised to Kw20 million and remained at that level until the banking legislation was finally revised in 1994, by which time it had been eroded by inflation to such an extent that it was equivalent to only \$30,000. Third, the Banking Act was unclear as to what was required of directors and managers of banks applying for licenses in terms of qualifications, experience, etc., and on what grounds applications could be rejected. The deficiencies in the licensing regulations allowed banks lacking strong capital and managerial resources to be set in the late 1980s and early 1990s.

The Banking Act did set out capital adequacy standards relating capital and reserves to liabilities minus liquid assets, and specified that minimum transfers should be made from profits into a reserve fund. But the capital adequacy provisions were largely meaningless in the absence of appropriate regulations regarding provisioning for doubtful debts and non accrual of unpaid interest. Hence a bank which was technically insolvent could appear well capitalised. Important omissions in the Banking Act were the lack of any references to insider lending and loan concentration. Moreover building societies, the Post Office Savings Bank and any other financial institution established by a written law of Zambia were explicitly excluded from the Banking Act.

The banking legislation was revised with the enactment of the Banking and Financial Services Act (BFSA) in 1994. The BFSA gives the BOZ more legal independence from the MOF: the Registrar is placed under BOZ control although the MOF must be consulted on licensing and other matters. It is more flexible than the previous Banking Act with the BOZ (or the MOF on the recommendation of the BOZ) having the authority to issue prudential guidelines and regulations (e.g. in regard to capital adequacy) and to demand regular data from financial institutions relating to prudential matters. The BFSA is also far more comprehensive in terms of both the type of financial institutions covered and the requirements demanded of these financial institutions and their directors.

The BFSA covers all financial institutions in Zambia. In granting licenses to financial institutions the Registrar must take account of the financial resources, experience and character of applicants and proposed directors. The minimum paid up capital for a bank has been raised to Kw1.25 billion (\$1.3 million).¹⁹ The BFSA imposes restrictions on loan exposure and insider lending, although the latter is less restrictive than in other banking

¹⁹ Banks already in operation have until 30 June 1996 to raise capital to this level. The BOZ is planning to raise the minimum capital requirement further to Kw2 billion.

legislation's on the continent.²⁰ It also imposes restrictions on shareholder concentration and, by stipulating that a majority of board members should not be officers or employees of the bank, provides for some degree of formal separation of the roles of ownership and management.

The BFSA gives the BOZ authority to take a range of measures, from issuing directives stipulating remedial action to revoking a bank's license, against banks that conduct unsafe or unsound practises or infringe provisions of the BFSA. In serious cases (e.g. when a bank refuses or is unable to comply with orders from the BOZ) the BOZ can appoint a curator to oversee the restoration of sound practises in the bank: the curator can recommend that the bank be wound up if s/he believes that it cannot be restored to a safe operating condition. Where the BOZ believes a bank to be insolvent it has the power to take possession of the bank and appoint a receiver.

Alongside the legislative revisions, measures have been initiated to strengthen supervisory capacities at the BOZ. A four year capacity building programme was started in 1994 to recruit and train bank examiners, a priority given that the supervision department is currently seriously understaffed.

The greatest test of the regulatory system so far was the failure of MBZ. Many of the events which led to its downfall occurred before the reforms to the prudential system were implemented, and as such do not necessarily reflect on the efficacy of the prudential system now in place. Nevertheless several aspects of the manner in which the MBZ affair were handled by the authorities must give grounds for serious concern, particularly with regard to the political independence of the BOZ to take decisive action when it is required.

First, there appears to have been an inordinately long delay in taking action against MBZ. MBZ continued to receive liquidity support from the BOZ long after it must have become apparent that the bank was in serious difficulties (other banks in Zambia had stopped lending to MBZ months before it was closed) and by the time it was closed it had accumulated an overdraft with the BOZ of Kw3 billion and had received government loans and deposits amounting to between Kw8 billion and Kw20 billion (Bull and Simpson 1995: 17-18).²¹

Second, the authority of the BOZ to deal with the crisis appears to have been severely constrained by the government, which suggests that the BFSA has done little to clarify their respective roles. The MOF is reported to have overruled the BOZ governor when the latter

²⁰ Aggregate insider lending is restricted to 100 per cent of capital, without approval of the BOZ. A limit of 25 per cent of capital is imposed in many other African countries. As of August 1995 the limits on insider lending in Zambia were only guidelines rather than regulations and thus could not be enforced by the BOZ. The BOZ was expecting the guidelines to be upgraded to the status of regulations.

²¹ The exact figures were not made public by the government.

recommended MBZ's closure in February 1995 and subsequently made more government money available to the bank. The governor was then sacked. After MBZ had been closed the MOF announced it was to be merged with ZANACO, an announcement which led to a run on ZANACO and had to be rescinded. The details of the Meridien affair have yet to be made public, but it is clear that large sums of public money were used to support the bank, much of which will probably never be recovered (Bull and Simpson 1995).

The problems among some of the local banks, discussed in Section 5, are likely to give rise to further cases of bank distress. Several of these banks are short of both capital and liquidity and their solvency is very vulnerable to defaults on their loans, especially in view of the current level of interest rates. Little will be gained by allowing undercapitalised banks to remain in operation: they are unlikely to survive long without a strong capital base to absorb financial shocks and their failure will have detrimental effects on public confidence in the other local banks. It is possible that some of the undercapitalised banks might merge so that their combined capital is sufficient to meet the minimum requirements of the BFSa, but those that are unable to meet the minimum requirements should have their licenses revoked.

To prevent the type of imprudent lending that has led to bank failures in other African countries, especially insider lending, and to ensure that adequate provisions are made for non performing loans, it is essential that bank regulators are able to closely supervise banks and monitor banks' loan portfolios, especially through on site inspections. Building up the supervisory capacity of the BOZ is therefore of crucial importance.

Effective supervision cannot however guarantee that no bank will fail, particularly in the difficult lending environment that prevails in Zambia. Bank regulators will face a difficult task in determining when a bank has become insolvent, or is close to becoming insolvent, before large losses are actually sustained and can no longer be hidden. The regulators will then have to take decisive action to prevent these losses from escalating. If there are long delays in closing distressed banks while attempts are made to find alternative solutions, as with MBZ, the likelihood is that the losses will accumulate further to the detriment of taxpayers and/or depositors. The BOZ should formulate and make public a clear set of rules for dealing with distressed banks (the 1994 BFSa provides it with the legal authority to take action when necessary). These rules should include the extent to which depositors will be reimbursed, limits on the amount of liquidity support any bank can receive from the BOZ, and the conditions under which the regulators should attempt to restructure a distressed bank rather than liquidate it. A rules based mechanism for dealing with bank crises can help to reinforce incentives for prudent management on the part of the banks and ensure that the regulators take decisive action when signs of distress emerge (Glaessner and Mas 1995).

8 CONCLUSIONS

The Zambian economy was subject to extensive government intervention during the 1970s and 1980s which made a major contribution to the long term decline of the economy. Interventionist policies were extended to the financial sector, with government owned banks set up, foreign non bank financial institutions nationalised and interest rates controlled. Despite this, the banking system survived reasonably well, at least until the second half of the 1980s. Zambia did not experience severe financial shallowing as occurred, for instance, in Uganda and Ghana; nor did the main government owned bank (ZANACO) accumulate huge losses as did its counterparts in many other African countries. Moreover the foreign banks retained a significant share of banking markets and continued to provide retail and corporate banking services.

The damage done by interventionist policies to the banking system was limited for two reasons. First, inflation was moderate until the mid 1980s, so that even though real interest rates were negative, holdings of monetary assets did not suffer a rapid erosion in their real value. Second, the main policy channel through which resources were allocated in the economy was not the banking system but the system of foreign exchange controls. This provided some form of protection for the banks against having to extend credit to uncreditworthy borrowers to meet developmental or political objectives, in part because it obviated the need for the government to impose detailed sectoral credit guidelines on the banks. In addition, given the scarcity of foreign exchange, access to foreign exchange provided borrowers with a degree of monopoly power which would have boosted their creditworthiness.

The resilience of the banking system to the mismanagement of the economy began to be eroded from the late 1980s onwards. Accelerating inflation induced a decline in financial depth as real interest rates became highly negative. Devaluation and the reduction in trade protection intensified the financial difficulties of the parastatal sector, with adverse consequences for the quality of ZANACO's loan portfolio, which was dominated by loans to parastatals. The growth of local private sector banks, many of which were undercapitalised, added to the fragility in the banking system, especially because prudential legislation and supervisory capacities were deficient.

Political constraints obstructed the adoption of a comprehensive and consistent structural adjustment programme in Zambia, and as a result financial reforms were delayed until the early to mid 1990s. Financial markets were liberalised in 1992/93 and new banking legislation was enacted in 1994 to accompany measures to strengthen supervisory capacities. The enactment of the Banking and Financial Services Act has considerably strengthened the legislative framework for prudential supervision although the personnel resources of the bank

regulators are currently very weak. Financial sector reforms are undeniably necessary to improve both the efficiency and the prudential soundness of the banking system but their implementation, particularly in regard to sequencing, may not have been optimal and a number of problems remain to be tackled.

Financial liberalisation consisted of removing interest rate controls and liberalising access to dealing in foreign exchange. Because of the acute macroeconomic imbalances which afflicted the economy in the early 1990s (large fiscal deficits and very high inflation) the introduction of market determined interest rates led to very steep rises in nominal interest rates during 1993 and 1994. This failed to halt the decline in the financial depth of the economy but is likely to have impaired loan quality and therefore intensified banks' financial fragility. It is unlikely that liberalisation will enhance efficiency in credit allocation until inflation has been brought under control and nominal interest rates reduced to more moderate levels. As such there would have been a case for delaying the implementation of financial liberalisation until the fiscal deficit and inflation had been reduced: the problem with such an approach is that liberalisation may have been delayed indefinitely.

Financial reforms have not yet included the restructuring of ZANACO, but this is likely to become increasingly urgent in view of the emerging magnitude of the problems in its loan portfolio. The size of ZANACO (its loans are equivalent to 2.8 per cent of GDP) mean that the potential costs of loan losses are high. It is imperative that ZANACO's problems are quickly diagnosed, and a restructuring programme put into place, including the revision of lending procedures to prevent further loan losses. A programme of loan recovery is also necessary. In the long term ZANACO's institutional status must be addressed in order to give the bank's directors and management independence from government and political interference. This will probably require its privatisation.

The growth of the local banks present a number of problems for the regulators, although they also offer potential benefits for financial intermediation by enhancing competition and extending access to credit to borrowers not served by the established foreign banks and ZANACO. There are too many local banks which lack adequate capital and managerial resources and are unlikely to be viable in the medium term, a situation which could have been avoided had the banking legislation been revised several years earlier, and had a more cautious approach towards bank licensing been adopted by the authorities in the early 1990s. Three local banks were closed down by the authorities in 1995, and their failure, and any others that occur in the future, will adversely affect public confidence in other local banks, making it much harder for even well managed local banks to attract deposits and provide competition to the established banks.

A major task facing the bank regulators now is to ensure that the local bank sector is rationalised at minimum cost to the taxpayer and without precipitating a systemic crisis. Undercapitalised and/or distressed banks should be closed down or merged with stronger private sector banks. Dealing with bank crises will be easier and less costly if the regulators can be insulated from political pressures to delay taking action against distressed banks or to accommodate their liquidity needs. A clear set of rules for resolving bank crises should be formulated by the BOZ and made public.

Despite its problems and those of the economy in general, Zambia's banking system is probably in better shape than many others in Africa, with at least a core of financially sound, mainly foreign, banks providing basic banking services. The major problems facing the industry are the acute macroeconomic instability, which makes lending very risky, the need to restructure ZANACO before any further losses are incurred, and the potential fragility among the local banks.

Table 1
Nominal Interest Rates and Inflation (%)

Year	Treasury Bill Rate	Savings Deposit	Lending Rate	Inflation
1970	3.1	3.5	7.0	2.2
1975	4.0	4.0	7.5	10.1
1980	4.5	7.0	8.5	11.7
1985	13.2	14.8	19.2	37.4
1990	26.4	23.5	37.5	109.5
1991	38.5	31.5	44.5	93.4
1992	46.5	41.5	55.8	191.3
1993	135.1	78.9	116.6	187.1

Sources: Musokotwane (pp 55 and 57); Bank of Zambia (1993: 42, 63 and 65); International Financial Statistics.

Table 2
Indicators of Financial Depth: M2/GDP and Bank Deposit/GDP Ratios: 1970-1993

Year	M2/GDP (%)	Bank Deposits/GDP (%)
1970	29.2	20.3
1975	31.2	24.2
1980	29.6	24.3
1985	29.7	24.8
1990	21.5	17.4
1993	14.2	11.0

Bank deposits are the domestic currency demand, time and savings deposits of commercial banks.

Source: International Financial Statistics.

Table 3**Banks in Zambia: Ownership and Dates of Establishment**

Period	Bank
Colonial Period	Standard Chartered (f) Barclays (f) Grindlays (now Stanbic) (f)
1965-79	ZANACO (g)
1980-85	Citibank (f) BCCZ (f) Indo Zambia Bank (f/g) Meridien (l) African Commercial Bank (l)
1986-90	Finance Bank (l) Capital Bank (l) Manifold Investment Bank (l)
1991-95	Union Bank (l) Commerce Bank (l) Credit Africa Bank (l) Prudence Bank (l) Safe Deposit Bank (l) First Merchant (l) Cavmont (l) *

Notes: (f) denotes a foreign owned bank; (g) a government owned bank; (f/g) a government/foreign joint venture; and (l) a locally owned private sector bank. Meridien was founded as a locally owned bank but expanded into an international bank with headquarters in Luxembourg.

* Merchant Bank.

BCCZ was taken over by Union Bank in 1991. Capital Bank was renamed New Capital Bank in 1992. Meridien, African Commercial Bank and Commerce Bank were closed in 1995.

Sources: Musokwotwane (p 48) and miscellaneous.

REFERENCES

- Adam, Christopher, 1995, 'Fiscal adjustment, financial liberalisation and the dynamics of inflation: some evidence from Zambia', **World Development**, 23 (5): 735-750
- Bank of Zambia, 1993, **Annual Report and Accounts**, Lusaka
- Bull, Theo and Simpson, David, 1995, 'End of the road for Meridien', **Profit**, June, pp 15-20
- Fardi, Mohsen A., 1991, 'Zambia: reform and reversal' in Thomas Vinod, Ajay Chhibber, Mansoor Dailami and Jaime de Melo (eds), **Restructuring Economies in Distress**, Oxford: Oxford University Press, pp 332-358
- Glaessner, Thomas and Mas, Ignacio, 1995, 'Incentives and the resolution of bank distress', **World Bank Research Observer**, 10 (1): 53-73
- Harvey, Charles, 1991, 'On the perverse effects of financial sector reform in anglophone Africa', **South African Journal of Economics**, 59 (3): 258-286
- _____, 1993, 'The role of commercial banking in recovery from economic disaster in Ghana, Tanzania, Uganda and Zambia', **IDS Discussion Paper**, 325
- Harvey, Charles and Jenkins, Carolyn, 1995, 'Interest rate policy, taxation and risk', **World Development**, 22 (12): 1869-1879
- Jones, Stephen, 1994, 'Structural adjustment in Zambia' in Willem Van der Geest (ed.), **Negotiating Structural Adjustment in Africa**, London and Portsmouth: James Curry and Heinemann, pp 25-46
- Kibazo, Joel, 1995, 'Meridien collapse - the inside story', **African Business**, June, pp 20-21
- Mulaisho, Dominic, 1994, 'The role of the central bank in economic liberalisation' in Nathan Chilepa Deassis and Stuart Makanka Yikona (eds), **The Quest for an Enabling Environment for Development in Zambia**, Ndola: Mission Press, pp 42-58
- Musokotwane, S., 'Domestic resource mobilisation and development in Zambia: 1970-1986', mimeo
- Mutukwa, Mebelo K.N., 'The financial repression hypothesis: an analysis with reference to the Republic of Zambia', unpublished, Oxford: Lincoln College

World Bank, 1991, 'Draft report on the commercial banking system in Zambia', Washington, D.C.: World Bank